**VERMONT YANKEE NUCLEAR POWER CORPORATION**

**BEFORE THE**

**STATE OF VERMONT**
**PUBLIC SERVICE BOARD**

**DOCKET NO. 6545**

**INVESTIGATION INTO GENERAL ORDER NO. 45**
**NOTICE FILED BY VERMONT YANKEE NUCLEAR POWER CORPORATION**
**RE: PROPOSED SALE OF VERMONT YANKEE NUCLEAR POWER STATION**
**AND RELATED TRANSACTIONS**

# DIRECT TESTIMONY

**SUBMITTED BY**
**DAVID J. EFFRON**
**ON BEHALF OF**
**THE VERMONT DEPARTMENT OF PUBLIC SERVICE**

**Summary:** Mr. Effron's testimony presents an estimate of the gain (loss) that would be recognized on the sale of VYNPS and recommends how such gain or loss should be incorporated into the continuing revenue requirements of VY if the Station is sold. He also presents certain modifications to the determination of the continuing VY revenue requirements assuming that the plant is not sold.

**JANUARY 7, 2002**

VERMONT YANKEE NUCLEAR POWER COMPANY
DOCKET NO. 6545
TESTIMONY OF DAVID J. EFFRON
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## I. STATEMENT OF QUALIFICATIONS

Q. Please state your name and business address.

A. My name is David J. Effron. My business address is 386 Main Street, Ridgefield, Connecticut.

Q. What is your present occupation?

A. I am a consultant specializing in utility regulation.

Q. Please summarize your professional experience.

A. My professional career includes over twenty years as a regulatory consultant, two years as a supervisor of capital investment analysis and controls at Gulf & Western Industries and two years at Touche Ross & Co. as a consultant and staff auditor. I am a Certified Public Accountant, and I have served as an instructor in the business program at Western Connecticut State College.

Q. What experience do you have in the area of utility rate setting proceedings?

A. I have analyzed numerous electric, telephone, gas and water rate filings in different jurisdictions. Pursuant to those analyses, I have prepared testimony, assisted attorneys in rate case preparation, and provided assistance during settlement negotiations with various utility companies.

I have testified in approximately two hundred cases before regulatory commissions in Alabama, Colorado, Connecticut, Florida, Georgia, Illinois, Indiana, Kansas, Kentucky, Maryland, Massachusetts, Missouri, New Jersey, New York, North Dakota, Ohio, Pennsylvania, Rhode Island, South Carolina, Texas and Virginia.

Q. Please describe your other work experience.

A. As a supervisor of capital investment analysis at Gulf & Western Industries, I was responsible for reports and analyses concerning capital spending programs, including project analysis, formulation of capital budgets, establishment of accounting procedures, monitoring capital spending and administration of the leasing program. At Touche Ross & Co., I was an associate consultant in management services for one year and a staff auditor for one year.

Q. Have you earned any distinctions as a Certified Public Accountant?

A. Yes. I received the Gold Charles Waldo Haskins Memorial Award for the highest scores in the May 1974 certified public accounting examination in New York State.

Q. Please describe your educational background.

A. I have a Bachelor's degree in Economics (with distinction) from Dartmouth College and a Masters of Business Administration Degree from Columbia University

## II. INTRODUCTION AND SUMMARY OF TESTIMONY

Q. On whose behalf are you testifying?

A. I am testifying on behalf of the Vermont Department of Public Service ("DPS").

Q. What is the purpose of your testimony?

A. Vermont Yankee Nuclear Power Corporation ("VY" or "the Company") is proposing to sell the Vermont Yankee Nuclear Power Station ("VYNPS" or "the Station") to Entergy Nuclear Vermont Yankee, LLC. The purpose of this testimony is to present an estimate of the gain (loss) that would be recognized on the sale of the Station and to recommend how such gain or loss should be incorporated into the continuing revenue requirements of VY if the Station is sold. I then present a forecast of the annual revenue requirements of VY subsequent to the proposed sale and convey this forecast to DPS Witness Biewald to be used in his present value comparisons of the proposed transaction to the "Own and Operate" cases. I also address certain modifications to the "Own and Operate" revenue requirements that are adopted by Mr. Biewald in his present value comparisons.

## III. GAIN OR LOSS ON SALE OF VYNPS

Q. What is the significance of any gain, or loss, that VY would recognize on the sale of VYNPS?

A. A gain on the sale of the Station means that the transaction would result in a recovery to VY greater than its remaining net investment in the Station at the time of the sale. Conversely, a loss on the sale of the Station would indicate that the net proceeds from the sale would not recover VY's remaining net investment at the time of the sale. I should point out that whether there is a gain or loss implies nothing about whether the price being paid for the Station is reasonable, as the book cost of the plant has nothing to do with its market value (assuming that the sale results in the plant's being removed from cost based ratemaking).

Q. What will be the disposition of any gain or loss that would be recorded on the transaction?

A. Any such gain, or loss, would be passed though to VY's customers, that is the Sponsors, in determining the continuing revenue requirements of the VY "shell" subsequent to the sale.

Q. Have you calculated the gain or loss that would be recognized on the sale of VYNPS?

A. Yes. My calculation of the estimated gain (loss) that would be recorded on the sale is summarized on Exhibit DPS-DJE-1, Page 1.

Q. Please explain this exhibit.

A. I have begun with gross proceeds from the sale of the Station of $180,000,000, the amount specified in the Purchase and Sale Agreement ("PSA") between VYNPC and

Entergy Nuclear Vermont Yankee, LLC. I then deducted an estimated $15,000,000 of transaction costs associated with the sale of the Station, resulting in net proceeds of $165,000,000. The transaction costs consist of a $7,000,000 premium on reacquisition of debt, $3,000,000 of auctioneer fees, and $5,000,000 of legal and administrative costs, as itemized on Exhibit DPS-DJE-1, Page 2.

Q. What does the $7,000,000 premium on reacquisition of debt represent?

A. The Company will be required to retire its outstanding mortgage bonds from the proceeds of the sale. Because the coupon rate on the bonds is higher than the currently prevailing interest rate on similar securities, the market value of the bonds is higher than the face value, and VY will have to pay a premium to reacquire and retire the bonds. The estimated premium paid on reacquisition is treated as a cost of the transaction.

Q. What is the next step in your calculation of the gain (loss) on the sale?

A. The next step is to deduct the book value of the assets sold from the net proceeds. For the purpose of calculating the net book value of the assets being sold, I have assumed that the sale will close July 15, 2002, and I have projected the depreciation and amortization of the assets being sold through that date. My calculations of the net book value are shown on Exhibit DPS-DJE-1, Page 3.

The first item is the net book value of the plant itself as of July 15, 2002. This balance includes construction work in progress as of that date. It also includes the

unamortized design basis documentation costs, although these costs are carried on the Company's balance sheet as deferred charges rather than in the plant accounts.

The second item included in the book value of assets being sold is net nuclear fuel. To calculate this item, I began with the $35,108,000 specified in the PSA and subtracted amortization of the final core through July 15, 2002.

The third, and last, item included in the book value of assets being sold is the net materials and supplies inventory. To calculate this item, I began with the $28,723,000 specified in the PSA and subtracted amortization through July 15, 2000.

Q. What happens if the actual nuclear fuel balance at the time of closing is different from the amount specified in the PSA?

A. If the actual nuclear fuel balance, exclusive of the amortization of the final core, at the time of closing is different from the amount specified in the PSA, the sale price will be adjusted accordingly. Thus, any difference will not affect the net gain that will be realized on the sale.

Q. What happens if the actual materials and supplies inventory at the time of closing is different from the amount specified in the PSA?

A. Similarly, if the actual materials and supplies inventory, exclusive of amortization, at the time of closing is different from the amount specified in the PSA, the sale price will be adjusted. Again, any difference will not affect the net gain that will be realized on the sale.

Q. What is the pre-tax gain or loss that you have calculated on the sale of the Station?

A. Subtracting the book value of assets being sold from the net proceeds, I have calculated a pre-tax loss of $(5,211,000), as shown on Exhibit DPS-DJE-1, Page 1. The next step is to calculate the income tax expense on the sale.

Q. How did you calculate the income tax expense?

A. The first step is to apply the combined state and federal income tax expense of 41.34% to the pre-tax gain or loss. This is what the net income tax expense recognized on the sale would be if deferred tax assets or liabilities had been recorded on all book-tax temporary differences. While VY has recorded deferred tax assets or liabilities, that is "normalized", the great majority of book-tax temporary differences, there have been some temporary differences that were flowed through in the calculation of income tax expense. The cumulative effect of the temporary differences flowed through is captured in the FAS 109 regulatory asset on the Company's books of account. At the time of the sale of the plant, the net FAS 109 regulatory asset will be written off and included in the income tax expense recorded on the sale of the plant. I have included the projected net FAS 109 regulatory asset on the Company's books of account as of July 15, 2002 in the income tax expense recognized on the sale of the plant.

There are two other items in the calculation of the net income tax expense, excess deferred income taxes ("EDIT") and unamortized deferred investment tax

credits ("ITC"). Both of these items are credits to income tax expense that increase the net of tax gain (or reduce the net of tax loss) recognized on the sale of the plant.

Q. Why should these two items be included in the calculation of the income tax expense on the sale of the plant?

A. If the plant is sold, inclusion of the EDIT and ITC in the calculation of the income tax expense recognized on the sale of the plant is appropriate for two reasons:

1. The EDIT and ITC represent previous tax savings to VY that have not been passed through to customers and are therefore, in effect, liabilities due to customers.
2. VY normalizes temporary book-tax differences, and crediting the EDIT and ITC against the income tax expense recognized on the gain (or loss) from the sale is consistent with the principles of normalization accounting.

Q. What gives rise to EDIT and ITC?

A. EDIT and ITC are the cumulative balances of certain property related income tax savings that the Company has realized but has not passed through to customers. Up to the time of the sale of VYNPS, these savings are being returned to customers over time, as the property to which these tax savings relate are depreciated on the Company's books of account.

Q. How did VY realize the tax savings represented by the EDIT?

A. VY normalizes book-tax temporary differences, mainly the difference between tax accelerated depreciation and book straight-line depreciation, and records deferred income taxes on its books of account related to these temporary differences. In recording deferred income taxes, there is an implicit assumption that the income tax rate will be the same when the deferred taxes reverse as it is when they originate. If there is a reduction to the income tax rate before the property is fully depreciated on the books of account, an excess in the balance of accumulated deferred income taxes ("ADIT") will be created. That is, the effect on income tax expense when the tax accelerated depreciation reverses will be less than the effect that was assumed under the previous higher tax rate. Hence, the deferred taxes that were accrued under the higher tax rate become excess deferred income taxes, or EDIT. The ADIT, including the EDIT, represent the cumulative balance of deferred income tax expense included in the cost of service and collected in rates from customers but not actually paid by the Company and are thus liabilities due to customers.

Q. How did VY realize the tax savings represented by the ITC?

A. Prior to 1986, qualifying property was eligible for an investment tax credit, generally equal to 10% of the cost of the property. This ITC was a dollar for dollar offset against the current tax liability of the taxpayer. Thus, for qualifying property with a cost basis of $1,000,000, the ITC would be $100,000, which would be a direct reduction to income taxes payable. When the ITC was realized it was not treated as an immediate reduction to income tax expense. Rather, the ITC was deferred and

then amortized to income, as a reduction to income tax expense, over the life of the property. The balance of ITC realized but not yet amortized to income is reflected in Account 255 – Accumulated Deferred Investment Tax Credits. As this balance represents the cumulative amount of reductions to income taxes not yet passed on to customers, it is a balance of customer-supplied funds.

Q. What happens in the case at hand if the EDIT and ITC are not credited against the income tax expense on the sale of VYNPS?

A. VY would then keep 100% of the EDIT and ITC for itself and its investors. Given that these balances are liabilities to customers, such a result would be inequitable. As these balances are liabilities to customers, they should be credited against income tax expense associated with the plant being sold, as normalization accounting requires.

Q. Why does normalization accounting require this treatment?

A. At the time of the sale, the proceeds from the sale are treated as revenue, that is as credits to the income statement. The remaining cost basis of the plant is treated as an expense that is charged against the proceeds from the sale of the plant. That is, the remaining book cost of the plant is, in effect, treated as depreciation expense recognized instantaneously at the time of the plant sale. Consistent with the immediate expensing of the cost basis of the plant, the remaining ADIT, including EDIT, and ITC must be reversed at the time of the sale. On these points, there is no dispute. Normalization accounting requires the reversal of ADIT, including EDIT,

and ITC at the time of the plant sale. The only question is whether the reversal of these deferred credits should inure to the benefit of investors or customers.

Q. How does VY intend to treat the EDIT and ITC at the time of the proposed plant sale?

A. Based on the response to VY:DPS:2-46, the Company intends to transfer these balances to a non-operating income account, claiming that such treatment is consistent with the normalization requirements of the Internal Revenue Code.

Q. Do you agree that transfer of these balances to a non-operating income account is consistent with the normalization requirements of the Internal Revenue Code?

A. No. The remaining cost basis of the plant is expensed at the time of the sale. To correlate the amortization of EDIT and ITC with the regulatory life of the related assets, as required by the Internal Revenue Code, EDIT and ITC must be flowed back in their entirety when the assets are sold. The flow back should occur in a manner that is consistent with the expensing of the remaining cost of the plant. That is, if the cost of the plant is treated as an expense that is the responsibility of ratepayers, then to be consistent, the EDIT and ITC should be credited against any tax expense recognized on the sale of the plant.

Q. With the inclusion of EDIT and ITC, what income tax expense have you calculated?

A. I have calculated a net income tax expense of $(5,518,000). Subtracting this amount from the pre-tax loss of $(5,211,000), the result is a net-of-tax gain of $307,000 (Exhibit DPS-DJE-1, Page 1). In substance, based on these estimates, the sale of the plant itself will be a break-even transaction, with no significant gain or loss. Of course, these estimates will change based on the actual proceeds and actual costs at the time of the sale.

Q. Are there other matters that will affect the gain or loss to be recognized at the time of the sale of VYNPS?

A. Yes. In my review of the transaction, I have identified two other matters that will affect the gain or loss to recognized at the time of the sale: the termination of the pension and benefits plans and the resolution of the regulatory liability related to the excess accrual for low level waste disposal.

Q. What will the effect of the termination of the pension and benefit plans be?

A. The PSA provides that the buyer will assume those obligations and the plan funds established to meet those obligations. As of December 31, 2000, the projected benefit obligation was $2,406,000 greater than the value of the pension funds as of that date. If this is the case as of the close of the sale of VYNPS, it is my understanding that VY will have to kick in $2,406,000 to make up the difference. However as of December 31, 2000, VY had also accrued $9,966,000 of excess pension liability on its balance sheet. If the pension plan is terminated, this liability will be reversed and credited to

income. Thus, the gain to be recognized on the transfer of the pension obligation to the buyer and the termination of the pension plan would be $9,906,000 - $2,406,000, or $7,560,000 before taxes (Exhibit DPS-DJE-1, Page 3). The actual gain or loss to be recognized at the time of the plant sale will depend on the actual projected benefit obligation, fund assets, and balance sheet liability (or asset) existing on the closing date of the sale.

Similarly, as of December 31, 2000, the projected postretirement benefit obligation (other than pensions) was $690,000 greater than the value of the plan funds as of that date. As of that same date, VY had accrued a net liability of $53,000 on its balance sheet. Thus, the net loss to be recognized on the transfer of the postretirement benefit obligation to the buyer would be $690,000 - $53,000, or $637,000 before taxes (Exhibit DPS-DJE-1, Page 3). Again, the actual gain or loss to be recognized at the time of the plant sale will depend on the actual accumulated benefit obligation, fund assets, and balance sheet liability (or asset) existing on the closing date of the sale.

Together, then the total gain to be recognized is $6,923,000 before income taxes, assuming that the funded status of the plans is the same at the time of closing as on December 31, 2000. The after tax gain is $4,061,000. As there will be changes from the end of 2000 to the closing date, the actual gain (or loss) to be recognized will most likely be somewhat different.

Q. What is the regulatory liability related to the excess accrual for low-level waste disposal?

A. The estimated cost of disposing of low-level waste is less than the FERC authorized collection amount. The Company has accrued a regulatory liability for the accrual in excess of the estimated cost of disposal. At the time of the sale of VYNPS, that regulatory liability will be reversed and taken into income. As of December 31, 2000 the regulatory liability was $1,751,000. If the balance is the same at the time of closing, the after tax income recorded on the reversal of this regulatory liability would be $1,027,000. The actual income will depend on the actual balance of the regulatory liability that is reversed at the time of closing.

Q. Is it possible that there will be other items that will affect the gain or loss to be recognized on the sale?

A. Yes. The PSA requires the reconciliation of certain assets and liabilities at the time of closing. For the most part, the reconciliation of these assets and liabilities should not have a material effect on the gain or loss that will be recognized, but the final calculation of the gain/loss will have to take account of the reconciliation of other assets or liabilities included in the transaction.

Q. Based on the assumptions described above what is the gain (loss) that you have calculated?

A. I have calculated a net after tax gain of $5,396,000 (Exhibit DPS-DJE-1, Page 1). On a revenue requirement basis, this gain is a credit to revenue requirements of $9,198,000.

Q. How do you recommend that this gain be treated?

A. If the Station is sold, this gain should be credited in equal annual installments to the continuing costs of the VY shell subsequent to the sale. On Exhibit DPS-DJE-1, Page 5, I calculate the annual revenue requirement effect of amortizing the gain over the remaining life of VYNPS (without license extension), with a return on the unamortized balance. I then calculate the present value of the amortization and return. Finally, I calculate the level annual credit to revenue requirements that produces the same present value. The present value of the return of and return on the gain on sale is $8,065,000 as of July 15, 2002. The level annual credit that produces the same present value is $1,232,000.

Q. How should this credit be incorporated into the VY revenue requirement?

A. The credit should be used to reduce the costs associated with operating VY subsequent to the plant sale. In effect, this credit will supplant the line items designated as Legal Expenses/Closing Costs, Depreciation, Final Inventory Amortization, and Fuel Amortization on Exhibit BW-10 with one line item to recognize the annual amortization, with return, of the gain (or loss) on the sale of the plant.

## IV. VY REVENUE REQUIRMENTS ASSUMING PLANT SALE

Q. Have you prepared a projection of the VY revenue requirements subsequent to the plant sale?

A. Yes. Assuming that VYNPS is sold, my projection of the VY revenue requirements subsequent to the plant sale is shown on Exhibit DPS-DJE-2. In general, this schedule is in the same format as Exhibit BW-10. However, there are some differences that require explanation.

Q. Please explain the entries on your Exhibit DPS-DJE-2.

A. As I stated above, I have assumed a sale date of July 15, 2002. Therefore, 2001 does not appear in my analysis, as it does on BW-10. The year 2002 reflects only the 5.5 months subsequent to the sale. This differs from Exhibit BW-10, which assumes a sale date of February 28, 2002 and includes expenses for the two months before, as well as the ten months after, the sale date in 2002.

The VY operating costs are the same as on BW-10, except 2002, which reflects operating costs only for the 5.5 months subsequent to the sale date. Similarly the interest expense (or income) is the same as on BW-10, except 2002, which again reflects the expense for only the 5.5 months subsequent to the sale. The NEIL insurance refunds for the years 2003-2007 are the same as on BW-10.

The amortization of the (gain) loss is the annual credit to expense calculated on Exhibit DPS-DJE-1. This line item combines the closing costs, depreciation, inventory amortization, and fuel amortization (exclusive of the DOE clean up costs) on BW-10. However, the amortization of the gain differs from the amount that would be calculated by condensing those line items on BW-10 because I have made an independent calculation of the gain on sale, as described above.

The DOE site cleanup costs are forecasted expenditures for the years indicated. BW-10 included this cost as part of the fuel amortization, although the expenses represent cash expenditures in the years indicated, not the amortization of an expenditure in a prior year.

The next item, terminal equity, represents the return of equity existing as of the end of the plant life (without license extension) in 2012. The Company model assumes that this equity will be retained through the operating life of VY. With operations complete in 2012, the life cycle of VY will be complete, and the remaining equity should be available in the form of cash to be returned to the VY owners. If the amount of equity existing at the end of plant life in the plant sale case differs from amount existing in the "own and operate case", this difference should be taken into account in comparing the present values of the two alternatives.

The income taxes are calculated based on the net income, by grossing up the net income to a pre-tax basis and calculating the income taxes on that pre-tax income. This is often referred to as the "return method" of calculating the income tax expense component of revenue requirements.

The net income was calculated by applying a return on common equity of 11% to the average book common equity for each of the years. As VY will continue to earn a regulated return on equity, I believe that this is a reasonable method to calculate net income.

The Purchased Power Agreement cost is the same as on BW-10, except for 2002. The cost for 2002 is calculated by multiplying the forecasted generation for the last 5.5 months of 2002 by the applicable rate for each of those months.

Q. What is the purpose of this forecast of VY revenue requirements subsequent to the sale of VYNPS?

A. I have conveyed this forecast of revenue requirements to DPS Witness Biewald to be used in his present value comparison of the proposed transaction to the "Own and Operate" cases.

## V. OWN AND OPERATE ADJUSTMENTS

Q. What adjustments to the "Own and Operate" case are you proposing?

A. I am proposing adjustments to the income taxes and net income included in the total revenue requirement. I am also proposing an adjustment to recognize the common equity existing at the end of the plant life (again assuming no license extension) in 2012.

Consistent with the method described above, income taxes should be calculated in the "Own and Operate" case by grossing up the net income to a pre-tax basis and calculating the income taxes on that pre-tax income. Net income should be calculated by applying a return on common equity of 11% to the average book common equity for each of the years. The purpose of the adjustment for terminal equity is to recognize the remaining equity at the end of the plant life that should be available in the form of cash to be returned to the VY owners. I have treated this adjustment as a reduction to the income requirement included in the revenue requirement in 2012. Again, these adjustments have been conveyed to Mr. Biewald to incorporate into the "Own and Operate" case in his present value comparisons.

Q. Does this complete your direct testimony?

A. Yes.